

# THE RICHBÄCHER LETTER

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## Bear Beginnings?

**“In the manic phase, people of wealth or credit switch out of money or borrow to buy real or illiquid financial assets. In panic, the reverse movement takes place — from real or financial assets to money, or repayment of debt, with a crash in the prices of commodities, houses, land, stocks, and bonds — in short whatever has been the subject of the mania”**

**Manias, Panics, and Crashes, Charles Kindleberger  
Basic Books, Inc., 1978**

The shock wave sweeping through the world's stock markets in the wake of the outburst of the Asian crisis has, for the time being, petered out. In America and Europe, stunning market declines have been succeeded by stunning rallies. On Wall Street, the Dow on October 27 hit a closing low of 7161.15, as against an all-time high of 8259.31. Bulls and bears are anxiously watching to see if it will come back to break through the all-time high of August 6.

If not, the bear market is here.

But what kind of bear market? That's really the most important question of all. A bear market lasting a few months, but then followed again by new highs? Or a truly savage, terminal bear market smashing through several thousand points of the Dow? Our endeavor is to find out. It is our long-held view that extremes both in financial leveraging and market valuations make a global stock market crash inevitable, and so it is, but inevitable is not the same as imminent. To look out for the critical juncture, then, remains the overriding task.

This letter is very much devoted to this question. First, we focus on the regional and global ramifications and implications of the Asian crisis and then on the U.S. economy and recent action on Wall Street. That's where the decisive action for the world economy and world financial markets takes place. The European markets have no will of their own. In their fluctuations and trends, they simply mirror Wall Street.

## ASIAN CONTAGION

When the Asian tremors began to hit stock markets around the world, policy-makers and financial pundits were quick to offer explanations as to why these events were of no great concern for the industrial economies. In one of his congressional testimonies, Fed-Chairman Greenspan even spoke of salutary effects of the Asian crisis on the U.S. economy.

*“Provided the decline in financial markets does not cumulate, it is quite conceivable that a few years hence we will look back at this episode, as we now look back at the 1987 crash, as a salutary event in terms of its implications for the U.S. economy. ...*

*By dampening the impetus of wealth effects on spending, the resulting net retrenchment should rather help to prolong the six-and-a-half year U.S. business expansion.”*

His statement implies that Wall Street no longer needs to fear a rate hike, something we have long said would not be a concern.

But, alas, his comforting comparison missed two crucial points: First, the crash ten years ago, as explained in the last letter, was in essence a tempest in trading rooms against the background of a strongly recovering world economy in which, most importantly, domestic and international debt and bubble problems did not yet exist. Second, these crashes in Southeast Asia and Japan reflect very serious, regional economic and financial troubles hitting an extremely unbalanced world economy that is vulnerable to abounding domestic and international debt problems.

Conjecturing that the fallout of the Asian tremors on the U.S. economy would be “modest, but not negligible”, Mr. Greenspan specifically noted that Thailand, the Philippines, Indonesia, and Malaysia (the four countries initially affected) buy only 4 percent of total U.S. exports, an additional 12 percent being bought by Hong Kong, Korea, Singapore and Taiwan.

Well, 16 percent as a whole is already something. Yet, even this ratio is deceptive. For a correct assessment of the importance of the region for the U.S. economy, the more appropriate measure is its share (ex Japan) in recent U.S. export *growth*, and that has since 1990, actually, been at a substantially higher 29 percent. As to Japan, the Asian region accounted last year for 40 percent of its exports. But its share in Japan’s export *growth* has over the same period been a whopping 70 percent.

Similar misleading calculations proliferate in Europe. It is generally claimed that Southeast Asia buys less than 10 percent of European exports. But when intra-European trade is netted out, just as U.S. data net out trade among the 50 states, the picture changes radically: Asian imports account for about 30 percent of all of Europe’s out-of-region trade. Moreover, EU exports to Asia have been soaring at double-digit rates.

The fact not to be overlooked is that the region has in the last years been the world economy’s locomotive, generating 60-65 percent of the growth in world output between 1990 and 1996. Asian GDP has in this period surged 90 percent, as against 20 percent for the OECD. Above all, it was the world leader in manufacturing investment, sucking in machinery imports from the rest of the world.

## **GLOBAL CONTAGION**

What started rather innocently in a small country called Thailand spread like wildfire to the whole region and then further to emerging markets in Latin America and Eastern Europe, pressuring, bonds, stocks, banking systems and currencies. By engulfing meanwhile also Korea and Japan, the Asian typhoon is definitely turning into a global threat. As Japanese stocks plunge, the viability of Japan’s financial system is increasingly in doubt.

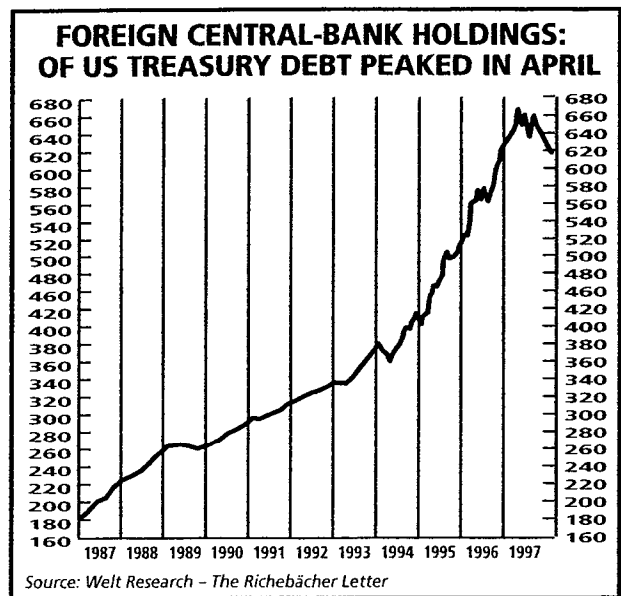
Pursuing the events, something struck us as rather strange, namely, the extraordinary stability of the U.S. government securities held by foreign central banks in custody at the Federal Reserve. Though down about \$35 billion from their \$653 billion peak in early April, this is an astonishingly small decline considering the tremendous scale of debt and currency problems in the region, involving several hundred billion dollars. It had seemed to us inevitable that the Asian central banks would be forced to sell substantial amounts of Treasury bonds from their huge holdings at the Fed, essentially spiking their yields.

## **THE GREAT GLOBAL RESCUE**

Actually, Thailand did so. Its Treasury holdings at the Fed are sharply down, even though the defense of the baht was mainly conducted through the forward and derivatives markets. But as the currency scare spread, one government after another, quickly capitulated to market pressure. With currencies overvalued and banking

systems fragile, the central banks simply could not afford to get dragged into a protracted battle for currency stability, draining reserves, hiking interest rates, and ravaging liquidity.

There was some further dumping of dollars and U.S. Treasuries from reserve holdings. Possibly, this was the cause of the brief spike in long-term U.S. Treasury yields in early October from 6.22 percent to 6.71 percent. In turn, this may have been the wake up call for Washington. In an apparent back flip, the U.S. Administration decided at this point to participate in the International Monetary Fund's bailout of a second Asian nation, Indonesia, having previously refused to do so in the earlier case of the IMF \$17.2 billion rescue package for Thailand (where the mess had started).



More than anything else, it was the attack on the Hong Kong dollar and the associated plunge of Hong Kong stocks that sent the big shock wave through stock markets around the world because Hong Kong was regarded as a bastion of extraordinary financial strength. Interest rates shot up, but mysteriously Hong Kong's huge hoard of dollar reserves of over \$80 billion have so far failed to show any reduction. Having realized that the U.S. Treasury must have a vested interest in keeping those stockpiles of bonds off the market, lest it would probably boost yield levels, we have been wondering why such sales haven't happened at least in the case of Hong Kong with its excessive dollar holdings. What if those holdings are instead used as collateral for dollar loans to finance the interventions in the currency market?

### **THE HIDDEN BENEFICIARY: WALL STREET**

Next, we wondered about the generous aid package for Indonesia. A \$10 billion facility provided by the IMF is bolstered by the involvement of the World Bank, the Asian Development Bank and contributions from the United States (chipping in \$3.5 billion) and virtually all governments around the region, adding up to a total of \$38 billion.

In a pretty critical article about the speed and generosity with which the Fund always rushes to the rescue of ailing currencies, the London Economist recently lamented that this would likely cause more problems in the long run than it solves in the short run by encouraging policy-makers to persist with bad policies and investors to take ever bigger risks in other emerging countries, confident of being bailed out. Significantly, soon after the most generous bailout on record, the \$51 billion dollar rescue of Mexico, capital flows into the emerging countries abounded as never before.

What the Economist and many others apparently do not appreciate is the fact that there are always two major beneficiaries of such bail-outs: the nations facing a meltdown in their currencies and financial markets and, second, a hidden beneficiary of which nobody talks but which is of overriding importance. That is the U.S. Treasury.

To grasp the vested U.S. interest in procuring rapid, prodigal international aid to ailing nations, one needs only consider the disastrous consequences that would arise if these such countries were forced to defend their currencies by drawing on their huge hoards of Treasury paper in their official reserves. A crashing bond market might well crush the stock market. By organizing the rescue of Mexico, Indonesia and other countries, the U.S.

Treasury also organizes its own rescue — and that of Wall Street.

## **THE NEW DEBT ORGY OF THE EMERGING COUNTRIES**

Already, the next and probably biggest IMF aid package — for Korea — is in the works. Though each country in the region has a slightly different set of parameters, the big problems are everywhere the same: a credit bubble, excessive investment in real estate and manufacturing, a large current-account deficit, mountains of bad loans, huge, unhedged dollar liabilities, a shaky banking system, and heavily geared corporations.

Yet Korea makes an important difference through its size. In terms of GDP and foreign trade it outdistances the whole region combined, implying a correspondingly bigger rescue. The needed financial infusion is put at between \$50 and \$100 billion, compared with \$17.2 billion for Thailand and \$38 billion for Indonesia.

No doubt, announcements of big aid packages by the IMF tend to boost confidence. We suspect that this is the case with the rescue program for Korea; there is a hope that the announcements of IMF aid will, by itself, prevent full-scale financial hemorrhage. The trouble is that there is less substance to those announcements than meets the eye. One is that the U.S. Congress has adjourned and will not return until January, having declined to vote on the White House's request for the \$3.5 billion it needs to fulfill its commitment to Indonesia.

The other dirty little secret is that the IMF's resources are getting stretched thin. The organization's principal source of funds are the "quotas" from 181 member countries, amounting to an impressive \$200 billion. But about half of that sum is fictitious because it is in the form of soft currencies that are of no use. Meanwhile the list of past and future recipients is rapidly lengthening. Not including Korea, only about \$50 billion are still available. To put this into perspective: Korea's short-term foreign debts amount to more than \$70 billion. For the troubled countries together, they may reach about \$200 billion.

Essentially, one has to wonder what will happen, and what can the IMF do, if the Asian crisis spills over to the emerging countries in Latin America and Eastern Europe. Given the persistent, extreme monetary looseness in the industrial countries, their current account deficits and corresponding burdens in foreign indebtedness have accumulated as never before. Between 1990 and 1996, the current account deficits and net capital and credit inflows of the developing countries have added up to more than \$ 1.1 trillion.

## **BETWEEN WORRY AND COMPLACENCY**

After initial sharp plunges, the stock markets in the industrial countries have calmed again.

Complacency is back. It was quickly hailed that the small investor had refused to panic. We are sure; he is the last one to exit once the bear market has started. He is hardly prone to worry about what is happening in far away Thailand and Korea. But wait, if the stock indexes will fail to beat their all-time highs of late July/early August within the next two-to-three months, what will then happen to his overconfidence?

As mentioned in the last letter, we see behind these wild stock gyrations not so much nervous investors as the frenzied activity of performance-driven traders on the part of banks, hedge funds and institutions. Operating with huge amounts and high leverage — largely through derivatives — they are explicitly in the markets for quick profits from quick trading, reacting and overreacting to every wisp of rumor or bit of news. Many a market rally may have no other reason than short-covering by such traders being caught on the wrong foot.

Still, this isn't meant to say that the first ferocious response of world equity markets to events in Asia could or should be discarded as unwarranted overreactions by traders. In our view, lack of knowledge on the one hand and a head-in-the-sand attitude on the other make for a general gross underestimation of the inherent risks and the possible, if not probable, global consequences of the Asian crisis.

## **DAMAGE APPRAISAL**

At its heart, Southeast Asia's economic and financial predicament stems from excessive "hot money" inflows that kept domestic interest rates lower than economic conditions warranted, and which fueled vastly excessive money and credit growth. What's more, most of the short-term debts were in foreign currencies, particularly U.S. dollars, to which the currencies of the regions were more or less strictly pegged. While central banks furiously accumulated reserves to prevent their currencies from rising against the dollar, so domestic banks were even more furiously accumulating foreign liabilities at interest rates far below domestic rates to fund a domestic borrowing and lending binge. On balance, the foreign liabilities soared in relation to reserves.

Given soaring bank reserves (owing to massive dollar purchases of the central banks), and virtually limitless offshore (Euro) borrowing (owing to capital account liberalization), the Asian banks ran amok in domestic lending, expanding it at annual rates of 25-30 percent. But, to take full advantage of the resulting currency mismatch, banks and corporations had to abstain from hedging the currency risk, which, of course, is now dangerously backfiring.

For sure, the region's policy-makers, ex Singapore, badly coped with the excessive money inflows. Rather, they welcomed them because it helped to keep interest rates low. But in fairness it has to be added that the origins of the region's present crisis go ultimately back to the artificially low 3 percent U.S. federal funds rate of 1992-93 — meant to stimulate the U.S. economy and to enable banks to repair their balance sheets following the bursting of the real estate bubble of the late 1980s. It marked the start of the global financial bubble.

The following figures show the net rise in the foreign debts of a number of emerging countries during the 1990s. They make horrific reading:

### **FOREIGN DEBTS OF EMERGING COUNTRIES**

	<b>Foreign Debt in US\$ billions</b>		<b>GDP</b>	<b>Current Foreign Debt</b>
	<b><u>1990</u></b>	<b><u>mid-1997</u></b>	<b><u>US\$ billions</u></b>	<b><u>as percent of GDP</u></b>
Korea	58	145	455	31.9
Thailand	30	101	185	54.6
Indonesia	70	130	227	57.3
Philippines	30	55	84	65.4
Malaysia	18	50	97	51.5
Brazil	120	195	749	26.0
Argentina	60	110	297	37.0
Mexico	105	160	335	47.8

*Source: World Bank*

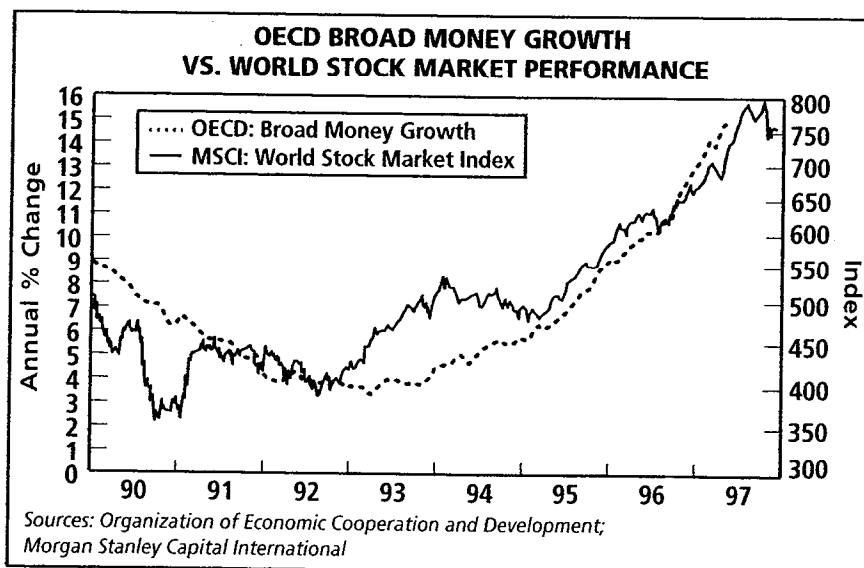
Consider the following detailed figures for Korea, the biggest country in the region. During the four years 1992-1996, the level of its external debts ballooned from \$60 billion to about \$136 billion. Within this total, short-term debts — in other words, the "hot money" component — skyrocketed from \$27 billion to \$69 billion. This compares with central bank reserves of recently \$31 billion. Domestic lending to the private sector, by the way, expanded in the same period overall by a whopping 110 percent, or 27.5 percent annually, going from an equivalent of 167 percent to 211 percent of GDP. Corporations are addicted to extreme gearing.

## FINANCIAL DEVASTATION

The greatest dangers unquestionably lurk in the financial sphere, as immense external debt problems cumulate with immense internal debt problems, discharging into an implausible blend of currency depreciation, massive wealth and liquidity destruction, and soaring bad loans jeopardizing the banking systems. If the Wall Street crash of 1929 and the Tokyo crash of 1990, both ending in prolonged economic and financial catastrophe, have at the very least taught one compelling lesson, it is the imperative need of keeping or restoring a viable financial sector. Those in Southeast Asia are already devastated.

Another comforting mantra about the situation in the Far East is the regular allusion to the fine fundamentals. True, like Japan, these countries have extremely high savings and investment ratios underlying their extraordinarily high economic growth. But the trouble is that, as in Japan, the deluge of bank lending was vastly channeled into real estate and manufacturing investment, eventually fueling excessive domestic demand and ballooning current account deficits.

As repeatedly explained in these letters, the most harmful effect of excess money and credit growth is not to be seen in rising consumer and producer prices but in the prolonged misdirection of resources, which ultimately brings about serious structural maladjustments. In Latin America, it was primarily the public sector that overborrowed and overspent. In Southeast Asia, the main culprit behind the inflationary borrowing and spending binge has everywhere been the corporate sector.



Huge malinvestments are the one essential upshot of credit inflation. Sliding collateral values and soaring bad loans are their essential counterpart. To have let their banking system rot under the crushing burden of such loans was the obvious, decisive mistake of the Japanese authorities in their attempts to resurrect economic growth. Whether or not the Southeast counterparts will be able to avoid this mistake is a key question that we tend to answer "No". For Southeast Asia this is not only a question of political will but, most

sorely, of financial potential. Estimates of non-performing loans in Southeast Asia, measured both as a share of total outstanding loans and as a percentage of GDP, are already well in excess of those in Japan in the early 1990s. Quite a few banks in the region already have negative equity.

Trying to assess the full financial damage in the region, another factor of great importance is the truly epic destruction of wealth and liquidity incurred not only by the banks, but also by corporations and private individuals. Marc Faber, resident in Hong Kong, gives in his Gloom, Boom and Doom Report an estimate that outside Hong Kong and Taiwan the richest 500 families in the region must have lost on average 50-70 percent of their net worth as a result of falling equity prices and currencies while their own wealth was largely tied up in their own companies' publicly traded shares.

The Bank Credit Analyst showed in its November issue the loss in equity capitalization for each country as a percentage of GDP. The weighted average loss is 44 percent in local currency, but with losses of over 70

percent for Thailand, Indonesia, Malaysia and the Philippines. Meanwhile, these losses have further substantially increased.

### **THERE ARE MANY MORE BUBBLES**

In hindsight, strong criticism has been directed against the rating agencies for their complete failure to give earlier warnings. What about the bankers' and fund managers' own responsibility? This smacks very much of looking for a scapegoat. To us, this Asian predicament is just another confirmation of how foolish all the talk is about the outstanding vigilance and efficiency of unfettered capital markets.

~~This glorious perception of the perfect efficiency of unfettered capital markets disregards the decisive prerequisite for efficient capital allocation. That is the necessity of limiting financial flows to available current savings, which of course is the task of monetary policy. By looking exclusively at consumer prices as their measure of inflation, the leading central banks of the world have allowed a virtually limitless global credit and money expansion which, underneath the booming financial markets, has fostered tremendous economic and financial maladjustments around the world.~~

Southeast Asia's bubble has been pierced. Many other bubbles remain. The consensus wants to equate IMF rescue packages virtually with the solution of a crisis. On the contrary, the Asian crisis has only just started. The next question is what will be the policy responses. It is of primary importance to realize that monetary policy operates in these countries under far more impinging conditions than in Japan. Their current account deficits and the heavy short-term foreign indebtedness make them hostage to fickle foreign "hot money".

This is, indeed, the all-important difference from the situation in Japan. With Japan's huge current account surplus, the central bank enjoyed complete freedom to slash its domestic interest rates to any desired level. Nevertheless, it hasn't worked. In Southeast Asia, the financial turmoil has driven short-term rates to high levels, where they are sure to stay for indefinite time. A weak banking system and a weak balance of payments can make an implosive mixture.

### **WAITING FOR GODOT**

While the markets seem to be settling down after their steep plunges, the inevitable painful economic adjustments have barely started. Even the very best policy measures take time to work. But even the adequacy and effectiveness of the policy responses have to be questioned. Who could have foreseen what a mess the Japanese policy-makers would make of the financial debris that resulted from the bursting of their asset bubble? Waiting for much better policies in these countries looks to us rather like waiting for Godot.

Earlier we stressed the stringent monetary complications and difficulties confronting these countries due to their weak balances of payment and high short-term foreign indebtedness. Yet their trade complications and difficulties are hardly less ominous. It begins with the urgent necessity of an export boom. Any hopes of avoiding a deep recession in the region rest on a roaring comeback of exports, which had in the last year plummeted.

Currency depreciations by 20-30 percent and more have of course strongly improved price competitiveness, but to realize booming exports more is needed: In particular, there must be other countries that are both able and willing to absorb more of SE Asia's cheaper exports. Which countries are these? Japan, China, Europe? Forget it. They are likewise relying on an improving trade performance for their own economic growth. For various reasons, both China and Japan are even sure to compound the region's problems, and vice versa.

## WARNING SIGNS FOR DOLLAR BULLS

Implicitly, all eyes go to the United States as the world's infallible, great sucker of imports. Taken for granted are the persistence of strong economic growth in the U.S., strong financial markets and a strong dollar. We put question marks behind all three.

Speaking of any contagion effects from Asia, the gurus have decided to focus exclusively on two potentially benign effects, and to disregard everything else. The one is cheaper imports capping consumer and producer price inflation. The other is capital flight into the safe haven of U.S. bonds. Both effects tending to lower U.S. interest rates. Together, it really is the height of complacency.

Dr. Pangloss, the obsessed optimist in Voltaire's *Candide* who gave every calamity he and his friend encountered a cheerful interpretation, must be turning of envy in his grave, listening to the Wall Street gurus. As to the "safe haven" flows, we would say that the savage wealth and liquidity destruction in the region is hardly prone to favor large capital outflows. On the other hand, it strikes us that no one mentions the abrupt cessation of the formerly massive U.S. Treasury purchases by Asian central banks exceeding for years \$100 billion annually.

*Only official flows into US treasuries are possible or*  
The second Panglossian point — that cheaper goods from Asia are likely to contribute to lower U.S. inflation — is of no better quality. Here, too, the flip side, consisting of a higher U.S. trade deficit and pressure on business profits, is in the same vein quietly passed over. Only time can tell, which of the three will be more important next year. So much for Wall Street's rectitude and rationality.

## HOW STRONG REALLY IS THE U.S. ECONOMY?

*Pseudo outflows are unlikely*  
Robert Rubin and Wall Street say the U.S. economy has the best fundamentals in the world. Many people will undoubtedly agree with this view. As we have repeatedly emphasized, we see one excellent fundamental — that is the flexibility of the labor market. But, otherwise, the macro-economic fundamentals that matter most — savings ratio, balance of payments, and productivity growth — are lousy. Upon closer inspection, the U.S. economy's recent strength is about bubbles, not about fundamentals.

"Wealth euphoria", fueled by the long, steep rise in stock prices, has become the drug that has kept the economy generally, and consumption especially, expanding briskly. The name of this game is bubble economy. Pointing to extraordinary corporate profit gains over recent years, Wall Street celebrates a "new paradigm" economy, implying that the stock market boom can continue on the back of efficiency gains claimed.

In answer, we can only repeat what we have said and proved many times before: There never was a profit miracle. The key factors behind the spurt of corporate earnings in recent years were several one-off windfall gains and systematic profit manipulations, not the great efficiency claimed by Wall Street. Otherwise, the profit performance would have been less than mediocre.

The windfall gains came mainly from plunging net interest expenses and, to a smaller extent, from lower tax rates and a disproportionately slow rise in depreciation charges. Nothing is easier than to check these facts. But who wants to destroy the profit illusion that has unquestionably crucially helped to boost stock prices? The main devices for profit manipulation have been the increasing use of stock options for employee remuneration, various accounting tricks, and corporate stock buybacks (boosting earnings per share).

Profit manipulations are sure to continue, but eroding windfall gains, slowing economic growth and rising

imports will batter profits. We wonder, to what extent the stock market's topping has also to do with escalating profit disappointments. It would be logical.

Loose money, the other main bullish force, is of course here to stay, however. Still, just by itself, it is not enough to keep the bull running. In addition, something is needed to make investors believe in the rationality of their stock purchases, and that is in general a favorable profit outlook. Regular vehement responses to even modest profit disappointments prove the case and should be taken as a warning. We are doing our best to spot critical changes in the U.S. stock market, regarding it as the bellwether for the rest of world.

### **WALL STREET WATCH**

With the S&P 500 only minimally below its all-time high, one might well think that bullish enthusiasm is back again. However, this index conceals a tremendous diversion between groups of stocks. The small caps are badly lagging (the Russell 2000 remains 8 percent below its October 13 high), the money center banks are sharply down (Citibank, 17 percent below its high; Chase Manhattan, 15 percent below its high). One area that has been hit particularly hard — and for good reason — is the semiconductor capital equipment companies; Asian semiconductor manufacturers are finally slashing their overly aggressive investment expenditures.

While the negative outlook for the industry has not been in doubt for some time, Wall Street has been strongly supporting this group until recently, completely ignoring the warning signs. In fact, they were favorites in the summer rally, many of them hitting all-time highs. It certainly was another good example of how today's U.S. market is run. Instead of discounting fundamentals, the stocks go into speculative runs and finally collapse when the bad fundamentals absolutely can no longer be ignored. The roster of tech stocks that have declined from their highs of last summer is a horror list, showing many plunges between 40 and 55 percent. The SOX semiconductor index is down 27 percent and the NASDAQ 100 is 10 percent below its level in late September, held up by a "flight to quality" — i.e., to Microsoft.

Looking back over the four months since its all-time high, the strong dollar combined with the escalating crisis in Asia and multiplying profit warnings in the U.S. provided ample reasons for a weaker market. Indeed, the once-thought infallible consumer multinationals provided the initial shock to investors. With a disappointing quarterly report from Gillette and profit warnings from others, including Coca Cola, selling quickly spread throughout the group.

Blatantly excessive valuations were quickly cut by as much as 20 percent for the likes of Coke, Gillette, Proctor & Gamble, Merck, Kellogg, McDonald's, Avon, Colgate-Palmolive, and Johnson & Johnson. Adding to nervousness was an overheated domestic economy and Mr. Greenspan's comments about the inflationary threat of tight labor markets and the unsustainability of such extraordinary economic and financial market performance. Additionally, troubling cracks were forming in the foundation of the mighty technology boom as a barrage of major earnings disappointments and a foretelling downgrade of leader Intel proved a precursor of difficult times ahead. Not helping matters either, British Telecom lowered their price for MCI, inflicting heavy losses on the arbitrage community.

Yet investors still largely closed their eyes to the growing risks. Money continued to flow into stocks, both through record mutual fund inflows and through red-hot mergers and acquisitions activity. At the same time, fund managers and traders alike were quick to embrace the rotation away from the consumer blue chips into small caps. Indeed, the Russell 2000 gained more than 15 percent because of the perception that its smaller companies stood to benefit from the strong domestic economy and at the same time have less to fear

from the economic tumult overseas because of minimal exposure to foreign currency positions. This much publicized rotation worked miracles for most mutual fund managers, who could finally boast of outperforming the major indexes.

In the financial sector, merger mania took over. NationsBank's unprecedented purchase of Barnett at four times book was rapidly followed by an even bigger deal — First Union's \$16 billion purchase of CoreStates Financial at an eye-opening five times book value. Remarkably, all the troubles challenging the global financial system were forgotten as pundits trumpeted, "U.S. financial assets have never looked better".

In similar euphoric fashion, there was a record issuance of securities from Wall Street: stocks, junk bonds, conventional corporate debt, Yankee bonds, mortgage-backed securities and other asset-backed paper. With ballooning bank syndications used mainly to finance mergers and acquisitions and aggressive strategies to securitize even traditional corporate loans, the stock market perceived an absolute wall of liquidity powering higher stock prices and continued economic strength with no end in sight. Broad money growth, fueled in particular by merger and acquisition financing, spurted to an annual rate of 10 percent, its fastest rate for many years.

Besides financial stocks, huge beneficiaries of this liquidity flood have been cyclical stocks. The transportation average gained more than 20 percent in two months, dropping its dividend yield below 0.8 percent. Airlines, whose valuations typically suffer due to highly levered balance sheets and very cyclical businesses, were viewed as particularly attractive, benefiting from a strong domestic economy and overly buoyant debt markets. Retail stocks became favorites as did the highly geared but earnings-deficient media companies.

In the technology sector, a dichotomy developed between, on the one hand, a long and growing list of profit disappointments and warnings and, on the other hand, stunningly resolute investor enthusiasm for equity exposure in this area. While the vast majority of technology stocks languished or even plummeted, a narrow group of personal computer, Internet and semiconductor stocks staged spectacular rallies. Compaq and Dell have two-month gains of 33 percent and 25 percent; Texas Instruments gained 20 percent as they became the darlings of the media.

As the S&P 500, NASDAQ composite, and Russell 2000 all peaked in early-to-mid October, the stage was set for a showdown between the over-heated US financial markets and an increasingly problematic environment complete with escalating international turmoil and a rapidly lengthening list of profit disappointments: Union Carbide, Eastman Kodak, Rubbermaid, Chrysler, Sears, Boeing, Allied Signal, Union Pacific, Intel, Sun Microsystems, Applied Materials, Seagate, and Western Digital among others.

### **BUYING THE DIPS**

On Wall Street, the October 27th record 554 point fall of the Dow, a loss of 7.2 percent, was in hindsight striking for its orderliness and lack of panic. In fact, with widely watched CNBC doing "play by play" analysis, the swooning market became a circus-like event. As the circuit breakers, implemented after the 1987 crash, halted trading first for one-half hour and later for the remainder of the day, volume was not exceptional. Mutual funds reported heavy call volume but only very moderate withdrawals. And, after a brief 200 point decline in follow-through selling at the opening of the next morning's trading, (rumored to be exacerbated by aggressive selling out of the Soros group in the S&P futures market), the market quickly reversed.

With the rally, the praise for the savvy and cool-headed small investor abounded on television and made newspaper headlines across the country. More noteworthy appeared the ensuing *buying* panic. On CNBC, cameras filmed long lines of people waiting to purchase mutual funds and open brokerage accounts. Record

trading volume surpassed one billion shares for the first time at the NYSE and almost 1.4 billion for NASDAQ. For the time being, the small investor once again proved an adherent of "buy the dip". With one-week losses for the Russell 2000 of 13 percent, 13 percent for the SOX index, and 16 percent for the NDX/NASDAQ 100, it was quite a big dip to buy!

But very soon the "buy the dip" wave petered out again. Instead, panic news from various Latin American markets, particularly the exceedingly vulnerable Brazil, boosted renewed selling. Simultaneously, growing recognition of the dire straits of the financial systems in Japan and Asia and their ramifications for large U.S. banks with significant international exposure began to spook the market. Citicorp, Chase Manhattan and J.P. Morgan traded off almost 20 percent from record highs. But, just as quickly, fears about Asia were replaced by euphoria about the merger and acquisition mania gripping the financial sector. Only time will tell whether these aggressive buyers weren't too anxious and generous for their own good.

The best performing stocks and sectors today are clearly those offering the most liquidity. These are the large caps comprising the S&P 500 and, interestingly, the perceived "defensive" consumer multinationals so weak earlier in the summer. The small caps, all the rage for the past few months, are notably underperforming. And, with most managers' portfolios now overweight this sector, this group appears particularly primed for disappointment.

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*"After the initial market plunge, the small investor was praised for refusing to panic. We are sure. He is the last one to exit once the bear market has started."*

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One group of stocks that now stands out for its new status as "underperformer" is technology, starting though from stratospheric levels. Two big afflictions that have been foreseeable for some time have finally arrived, and with a vengeance. The one is staggering global overcapacity. The other is a combination of disappointing sales with a dramatic shift to low-priced computers. Let's face it: there is simply not a lot of money to spread around in a \$1,000 dollar computer. While unit growth is still substantial, collapsing prices have led to near-stagnant revenue growth. It appears that investors are just waking up to the rapidly deteriorating prospects for the vast majority of tech companies, something we have started to warn of many months ago.

With the global financial market sell-off, the leveraged speculators had no place to hide. Rumors of hedge-funds in trouble have been sweeping the markets. A small but well known hedge fund manager lost his remaining assets writing put options on the US market after suffering sizable losses invested long the Thailand market this past summer. There is talk of bank insolvencies in Brazil related to leveraged speculations in that country's Brady bonds, which, generally, have been in a free fall throughout Latin America. While the scope of the US banks' exposure to the unfolding global crisis is not clear, Chase Manhattan disclosed a \$160 million trading loss on derivatives. It could prove to be the tip of the iceberg.

What a difference from the discussion of over-liquefied markets just one month before! Today's environment, with derivative exposure in trillions of dollars hidden off balance sheets, is of course prone to spawn rumors of more banks in trouble. As market trends get blurred by ever greater, erratic fluctuations, the risks and the risk-taking will grow immensely. There is great trouble down the road. What is clear, however, is that we have seen a considerable deleveraging in emerging debt markets. As we have always suspected, the great bull market for those securities over the past two years was nothing but a huge speculative bubble from borrowed money.

## CONCLUSION

After the first financial and psychological shock waves from the Asian crisis have passed, the bullish consensus wants to believe that the worst is over. In reality, the necessary painful economic and financial readjustments have only just started. They couldn't be avoided even with the very best policy responses. Be prepared for inadequate and bad policy responses.

Western stock markets have suffered, but the greatest, immediate threat is that investors and lenders may be scared away en masse from engagement in the emerging countries as a whole. Altogether, their cumulated internal and external debt problems are vastly too big to be papered over by the IMF and central banks, as the foreign "hot money" locked into the markets of these debtor countries runs into many hundreds of billion of dollars.

Considering that the world economy has for years been drowning in excess credit and money, any talk of deflation is humbug. We agree with the view that deflationary pressures are developing — in particular in asset markets. But the key point to see is that these deflationary pressures accrue from maladjustments fueled by inflationary, and not from deflationary, policies.

Central banks keep their money spigots wide open. What we are witnessing is the bursting of a global credit and asset bubble that has created unprecedented global imbalances and indebtedness and absurdly overvalued stock markets.

In Japan, the question is no longer whether enough is being done to stabilize the financial system but whether it is possible to avoid a ravaging financial crisis and credit crunch. To head off a liquidity squeeze, the Bank of Japan injected the equivalent of \$23 billion into the money market.

The deteriorating global environment is bad news also for western stock markets. But for the time being, they prefer to focus on the sunny side of probably even looser money. We keep a particularly keen eye on Wall Street as the global pacesetter. While U.S. stocks have overall done pretty well, grave dangers loom in two areas that have been pivotal for the long and strong bull run: proliferating profit disappointments are the one; escalating trouble in the computer industry is the other.

These wildly speculative markets are unpredictable in the short run, but the thing to see is that the risks on the downside grossly outweigh the remaining mini-potential on the upside. ■

### THE RICHBÄCHER LETTER

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